Interview by Vinson & Elkins
with Lawrence Grissom

at footnote(s):

264, 265, 267

Vinson&Elkins

Memorandum

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Date: March 7, 2005

To: Richard C. Sauer
Paul S. Maco
William E. Lawler, III

From: Nashiba Boyd

Re: City of San Diego; Interview with Lawrence Grissom

This memorandum summarizes the interview of Lawrence Grissom on February 14, 2005. This memorandum does not contain a verbatim or near verbatim transcription of this interview, but rather is a general summary of my thoughts and impressions regarding our discussion. It is organized to summarize issues thematically and does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case, and does not provide context or explanation of every factual reference. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the work product privileges, and it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

Mr. Sauer conducted the interview, with the participation of Bill Haegele, KPMG. Mr. Grissom was represented by Mike Leone. I participated by telephone.

Mr. Sauer began by asking Mr. Grissom about an issue concerning SDCERS that had received recent press coverage in San Diego, the allegation made by CERS Trustee Diann Shipione that CERS frequently paid benefits to deceased system members. Mr. Grissom said that every retirement system has that problem because it is impossible to know immediately when a retiree has passed away. He stated that CERS is, to his knowledge, no different from other systems in that regard. It has various information sources, including the Social Security Administration and a national data base that picks up information submitted by funeral homes, which CERS checks once a quarter. Ms. Shipione's allegation that it relies exclusively on the obituary columns in local newspapers is not accurate. Often when amounts are paid to deceased retirees (partly a function of automatic electronic deposits) they can be recovered through set-off against retirement benefits. He estimates that they lose $8,000-20,000 a month in write-offs, far less than the amount lost by bigger systems like PERS.

Next Mr. Sauer inquired about Mr. Grissom's understanding of the way in which the City accounted for its net pension obligation. Specifically, he asked about any discussions at the time of Manager's Proposal 1 concerning whether the City would have to recognize a liability for its NPO. Mr. Grissom remembered some confusion over this issue. His initial understanding was that the NPO could be paid down from funds set aside from surplus earnings so that no liability would be reported by the City. Later he learned that this was incorrect. It is an expense to the City that is amortized in a difference schedule than the UAAL.

Questions relating to emails. Mr. Sauer provided copies of a number of emails and asked Mr. Grissom various questions about them. Those emails are appended to this summary.

09/13/98 email from Terri Webster (forwarding email from Ed Ryan). Mr. Sauer asked whether City officials were concerned with the rating agencies' reaction to the City's net pension obligation (the "NPO"). Mr. Grissom responded that there was but he could not recall the context or time frame when the actuary first determined there was a reportable NPO. He thought it may have been 1996 or 1997. Mr. Sauer asked whether it was after the advent of Manager's Proposal One (the "MP1"). Mr. Grissom said yes and that after MP1 there was confusion on how the NPO should be treated because it was an item that needed to be reported on the City's books and amortized but that did not need to actually be paid down. Mr. Sauer asked what happens to the NPO if the funding level reaches 100%. Mr. Grissom responded that each year the actuary figures out the amortization of the NPO on a schedule that is separate from the UAAL as a whole. Mr. Sauer asked if the amortization of the NPO was reported as an expense of the City and Mr. Grissom responded that it is. Mr. Sauer asked what was the time period of the amortization schedule. Mr. Grissom was not sure but he believed that each annual NPO was on a separate 40-year schedule. Mr. Sauer asked whether the amortization of the NPO affected the City's contribution rate. Mr. Grissom said that it did not.

Mr. Sauer asked whether it was Mr. Grissom's idea to cover the NPO out of the pot of money. Mr. Grissom said that he recommended that they pay the NPO out of accrued undistributed earnings on an annual basis. Under this plan, the NPO would be treated as an expense item. Mr. Grissom said that he now knows that he misunderstood the nature of the NPO. Mr. Sauer asked Mr. Grissom what happened to make him realize his mistake. Mr. Grissom replied that he discovered his mistake after a conversation with the actuary. Eventually the actuary decided that the NPO Reserve served no purpose and should be folded into the Employer Contribution Reserve.

Mr. Sauer asked about whether the city staff expressed concern about how the rating agencies would view the NPO. Mr. Grissom said that the discussion, typically involving Ed Ryan, Bruce Herring and Terri Webster, came up in the context of each year's actuarial valuations and also during consideration of Managers Proposal Two ("MP2"). Each year, the conversations were triggered by the actuary's annual evaluations beginning in 1997 or 1998. The conversations intensified at the end of the 1990s and peaked in 2000. Mr. Sauer asked whether as the funded ratio went down and the UAAL went up, the conversations about the rating agencies intensified. Mr. Grissom said that they did. He also stated that, among CERS board members, Ms. Webster and Ms. Vatimo were the driving forces behind the rating agency conversations. Mr. Grissom said that they were concerned because a decline in the bond ratings would cost the City money. He also said that he was not directly involved in these conversations, but that he overheard them while the board was working.. Mr. Sauer asked whether he observed an effort on the part of any board members to withhold information from the bond rating agencies or mislead them. Mr. Grissom said that he was unaware of any such conduct. Mr. Sauer asked whether anyone suggested actions to make the situation appear better than it was. Mr. Grissom said that was not the case.

Mr. Grissom said that he would get calls in September and October about the actuarial reports. He said that the retirement board documents were public and he would get extra copies of them and keep them in a permanent file and his office to give to the press and members of the public.

03/16/01 email to Larry Grissom from Terri Webster. Mr. Grissom said that this email establishes the time frame when he realized that his previous understanding of the way the NPO would be accounted for was not correct. He said it is also possible that Ms. Webster may have come up with idea for NPO reserve. Mr. Sauer asked Mr. Grissom if he understood what Terri Webster meant by the phrase "I recall it being more political". He replied that he did not. Sauer asked whether it was Mr. Grissom's idea to cover the short fall from MP1 in reserves taken from surplus earnings and he said it was. He wanted to calculate the underpayment and zero it out with funds transferred from reserves. However, this did not work; the reserves did not change the actuary's bottom line. It had no practical effect.

Mr. Grissom said that the City first reported an NPO in 1997. Mr. Haegele noted that the reported amount was $5.9 million but would have been $7.2 million had the actuary not changed his approach to amortizing the UAAL. He referred to a letter from Rick Roeder to accountant Mike Phillips about the "new assumptions." Mr. Grissom was asked by Mr. Haegele whether he had any recollection of Mr. Roeder saying to the City could have a different amortization period for expensing purposes than for calculating its contributions to the system. Mr. Grissom said he had numerous conversations with the actuary about this issue because Mr. Grissom found this hard to understand. Mr. Haegele asked if there was any legitimate reason an actuary would look for reasons to reduce the ARC; isn't his job simply to get the best numbers? Mr. Grissom replied that there can be various approaches that are acceptable under actuarial standards. He also stated that the NPO calculation did not affect the amount contributed by the City to CERS.

Mr. Grissom said that when there are various acceptable options, the actuary will usually present those options to the board and recommend but not demand a particular option be adopted. If the board disagrees with the actuary's recommendation, he may put a note to that effect in the comment section of his report. This "covers his backside." He said an actuary can do one of three things: tell the board a particular option is entirely elective; tell them it is permissible but comment on it in his report; or tell them it is simply not allowed.

An example of the board not following the actuary's recommendation is the *Corbett* litigation. The lawyers believed that *Corbett* was a contingent liability and therefore should not be included in the UAAL. The actuary thought it should be included because it would eventually be paid. Mr. Sauer asked why the board chose not to include the *Corbett* liability in UAAL. Mr. Grissom said that Cathy Lexin and Mary Vatimo swayed the other members of the board not to include the liability because it would increase the liability of the City. Mr. Sauer asked whether any concern was expressed over the effect on the bond agencies of recognizing the "contingent" element of Corbett and Mr. Grissom did not remember any Mr. Sauer asked whether increased liability was recognized by the City representatives as bad for the bond ratings. Mr. Grissom said yes.

Mr. Haegele noted that, under GASB, changes in assumptions should be rare. Mr. Grissom stated that Mr. Roeder is a straight actuary and must have believed that changing certain assumptions was the right actuarial thing to do. Mr, Sauer asked whether Mr. Roeder was ever pressured by CERS board to change assumptions in a way that he was not comfortable with. Mr. Grissom said that it was always give and take with assumptions. An example of this would be turnover rates. The City pays a portion of the employee contribution rate and discounts its contribution based on employee turnover (resulting in employees who never qualify for pension benefits). When turnover went down, Mr. Roeder recommended that the discount be decreased. The effect would be an increase to City contribution rates. When this happened, City officials questioned whether the turnover rate was correct. Mr. Grissom said this put pressure on Mr. Roeder, but he held firm. Mr. Roeder, however, did agree to phasing in the discount. .

Mr. Sauer asked whether the *Corbett* litigation was reported as a contingent benefit because of the effect on City's bond ratings. Mr. Grissom said not specifically. The City always fussed over any actuarial figure that would increase the amount it had to pay and attempted to minimize its contributions to CERS. City officials who were also CERS board members were sensitive to costs to the City of particular measures. He said that the state constitution says that the first obligation of the retirement board is to the beneficiaries and then to minimizing the expense to the City. Mr. Sauer asked whether in his view the City officials were reversing this order but Mr. Grissom said he did not believe so

02/12/02 email from Terri Webster to Ed Ryan. Mr. Sauer asked whether Mr. Grissom remembers having a conversation with Terri Webster about the actuarial report on the day that it came out (February 12, 2002). Mr. Grissom did not specifically remember such a conversation. He said that the February board meeting was on the 15th of the month and he remembers that he held the report and distributed it at the meeting. It was logical that Terri Webster would have contacted him to discuss the report.

Mr. Sauer asked whether Mr. Grissom remembers discussing the trigger mechanism. Mr. Grissom said that he did. There was a decrease in asset level and he started getting questions about whether they would hit the trigger at the next valuation. Mr. Sauer asked whether Mr. Grissom remembered when these conversations took place. Mr. Grissom said that it took place around the MP2 time period. It was an often-stated concern during the discussion of MP2. MP2 was discussed in the spring of 2002 and the actuarial report for June 30, 2001 was released in February 2002. Thus, it was March or April 2002 when the discussion of the triggering mechanism took place. Mr. Sauer asked whether the discussion began after the actuarial report and Mr. Grissom said it did.

Mr. Sauer asked whether Mr. Grissom had preliminary indications of any of the June 30, 2001 numbers. Mr. Grissom said that he was informed of bits and pieces of the report. He would submit numbers to the actuary in July that would factor in the actuary's report, as eventually released. The actuary would occasionally ask Mr. Grissom questions about the accuracy of the data that was submitted in July. Mr. Sauer said that Mr. Grissom earlier stated that people would call him up before the report was released seeking information. If he had no preliminary information, what purpose did this serve?. Mr. Grissom said that his job requires that he have knowledge of actuarial matters that allows him to form educated guesses about where numbers would come out. He does not like to make predictions, which is why he has not done so in three to five years.

Mr. Sauer asked whether Mr. Grissom gave predictions prior to February 2002. Mr. Grissom said the he would intuitively look at investment reports and see losses and he also was aware of the *Corbett* liability. He knew that things were going south. Mr. Sauer asked whether there was any effort prior to February to determine whether the trigger would be hit. Mr. Grissom said that there was not.

February 12, 2002 Email from Terri Webster to Mary Vatimo – Subject: FY2002 earnings. The email indicates that Terri Webster asked Mr. Grissom what he thought the funding ratio would be for FY2002. Mr. Grissom stated that this question was asked many times, often by Terri Webster, but he refused to guess.

Mr. Sauer noted that Mr. Grissom had the actuary reports from the previous June (release in February 2002) and the investment reports. He then asked whether Mr. Grissom had any information about changes in actuarial assumptions. Mr. Grissom said that he did not. Mr. Sauer asked if, based on the information, he had, he was in a position to make an educated guess? He said he had no firm idea of how the numbers would come out; however, he may have commented on how things looked thus far. Mr. Sauer asked why Terri Webster was asking Mr. Roeder to make predictions. Mr. Grissom said that Terri Webster was concerned about the City's bond ratings. He said Mr. Roeder was not able to satisfy her inquiry.

February 28, 2002 Email from Terri Webster to Larry Grissom – Subject: Change a few things. Mr. Sauer asked Mr. Grissom what Terri Webster meant when she said, "ain't life fun." Mr. Grissom said she was referring to the Blue Ribbon Committee report. Mr. Sauer asked whether the CERS staff had any involvement in the Blue Ribbon Committee report. Mr. Grissom said that they did not, but Terri Webster met with them on two occasions to obtain information for the committee.

Mr. Sauer asked what Terri Webster meant when she said they had "work to do." Mr. Grissom said that he was unsure but it was obviously concerning items in the report. Mr. Sauer asked whether Terri Webster suggested any short-term solutions to the trigger issue. Mr. Grissom could not recall any. Mr. Sauer asked whether there was discussion of recommendations that would not affect the funding ratio. Mr. Grissom did not recall any. Mr. Sauer asked whether there was a proposal made during the Spring of 2002 that affected the trigger mechanism. Mr. Grissom answered affirmatively, but stated that he could not place the exact time of the proposal. There was a meeting with Cathy Lexin and Mary Vatimo in which they proposed reducing the trigger to 70%. Mr. Grissom said that he told them to make whatever proposal they wanted but he would not support 70% and he thought it had no chance of being adopted. The proposal was then raised to 75% before it went to the board. Mr. Sauer asked who proposed 75%. Mr. Grissom said the proposal came from the City Manager's Office.

Mr. Sauer asked whether there were any other ideas other than lowering the floor. Mr. Grissom said that other suggestions included potential changes in the earnings assumptions and longer amortization periods. Mr. Sauer asked who made those propositions. Mr. Grissom said that Cathy Lexin and Bruce Herring were parties to the discussions. Mr. Sauer asked why these proposals were not adopted. Mr. Grissom said because he discouraged them. Mr. Sauer asked whether the proposals were matters for the actuary to decide. Mr. Grissom agreed but said that it was also a part of his job.

Mr. Sauer asked what hitting the trigger would have meant in terms of the City contribution levels. Mr. Grissom said that the fiduciary letters touched upon this. He said that the trigger would increase the City contribution rate to the actuarial rate. Other people had the view, however, that according to the language of MP1, if they went through the trigger level the City would have had to put in the dollars necessary to bring the funding level back up to the trigger level.

Mr. Sauer asked whether Mr. Grissom was involved in drafting MP1. Mr. Grissom said that he misspoke earlier. He meant to say that he was involved in the writing of the rules to implement MP1. Mr. Sauer asked who wrote MP1. Mr. Grissom said that he was not sure. He thinks it was the City manager's office. Mr. Sauer asked whether there were calculations done for competing interpretations. Mr. Grissom did not recall but there was discussion of the different interpretations. He was not sure if there were any written documents of those conversations.

02/28/02 email from Terri Webster to Ryan, Vatimo and Lexin. Mr. Sauer asked Mr. Grissom if he remembered any discussion of the statement in this e-mail that CERS earnings for January were negative and that they were moving in the wrong direction. Mr. Grissom said that the investment officer made predictions of what earnings would be. Mr. Grissom said that he resisted these predictions. He believed that, just like any other statistical analysis, the investment officer could be wrong. The predictions were beginning to point to negative earnings for FY 2003. Mr. Sauer asked what was the "problem" that Terri Webster mentioned in the beginning of the email. Mr. Grissom said the system had actually lost money, which had not happened before.

Mr. Sauer asked whether the primary concern was that contingent benefits would not be paid. Mr. Grissom said that it was a major concern, but not the primary concern. They were concerned with other things such as the employee contribution reserves declining. The question arose of what would happen if there were not sufficient earnings to pay the 8%

interest on the employee contribution reserve. Counsel Robert BLum advised that this would have to be paid from the Employer Contribution Reserve.

Mr. Sauer asked whether Ron Sathoff played a pivotal role in the CERS decision to approve MP2. Mr. Grissom said that Mr. Sathoff was the longest tenured member of the retirement board. He was very knowledgeable about the impact of benefits and does a good job of arguing his points

04/18/02 email from Larry Grissom to Terri Webster. Mr. Sauer asked whether there were discussions about the changing the rate of return assumptions. Mr. Grissom said he has a vague memory of such a discussion. Mr. Sauer asked whether it would have helped avoid the trigger to raise the rate of return assumption. Mr. Grissom said that he did not think so.

04/26/02 email from Cathy Lexin to Terri Webster. Cathy Lexin in the emails stated that Mr. Grissom gave a 80% projection of the funding ratio. Mr. Sauer asked whether he remember the projections. Mr. Grissom said he is not certain, but he is surprised that people thought that he gave specific numbers. He also said that he would have felt comfortable making a projection about the investment side.

In 1997, the City started the purchase of service program. The price was increased in 2002 because changing demographics meant that many system members were effectively purchasing years at a discount form the actuarial level. Mr. Grissom said that he had a conversation with the board, urging it to increase the cost to purchase service credits because when they were sold at less than the actuarial rates, they created a liability. Mr. Sauer asked when the increase was effected. Mr. Grissom said that the new valuations began to take effect fiscal in FY 2004.

07/02/02 email from Ed Ryan to Terri Webster. The email discussed the *Corbett issues*. Mr. Sauer asked whether this was at the time when *Corbett* contingency was being considered by the board. Mr. Grissom said that it was very likely that the discussion was over by that time. He is unsure why the issue was being discussed again here. Mr. Sauer asked whether it was true that the rating agencies did not follow pension-funding issues. Mr. Grissom said that he did not know. Mr. Sauer asked whether Mr. Grissom knew if Terri Webster or anyone else wanted to avoid drawing attention to the pension funding. Mr. Grissom said not to his knowledge.

07/11/02 email from P.B. Nugget. Mr. Grissom said that P.B. Nugget was, in fact Dave Crow, the elected representative of retirees on the board. He also stated that he was unsure what the reference to the "13th check" meant. Mr. Sauer asked what was the motion made by Mr. Sathoff on the day that the MP2 came before the board. Mr. Grissom said that there was also a special meeting on that date and Mr. Satoff made a proposal to keep the 82.3% floor. Mr. Sauer asked what "all my questions not answered" meant. Mr. Grissom said that the proposal was heard on July 11, but formal approval did not occur until November. There were specific issues that still needed to be worked out.

Mr. Sauer mentioned that Mr. Blum (fiduciary counsel) had agreed that the board would not breach it's fiduciary duty if it accepted the MP2. He then asked whether the board sought a second opinion. Mr. Grissom said that they did not. Mr. Sauer asked whether there was any indication that Mr. Saathoff was influenced in his vote by the union President's Resolution. Mr. Grissom replied no. Mr. Sauer asked whether there was any indication of quid pro quo involving any of the board members voting for MP2 to obtain personal benefits. Mr. Grissom said no.

07/15/02 email from P.B. Nugget (David Crow) to Larry Grissom. The email stated that seven out of eight board members voted for a pay raise. Mr. Crow said that last week's meeting was a sham. Mr. Sauer asked whether the deal was, in fact, done before the vote. Mr. Grissom said no, that Mr. Crow was merely expressing his opinion of the vote. Mr. Grissom said that he did not agree with the claim that the vote was a sham. There was a lot of bitterness, but Mr. Crow did not express it outside of the email. Mr. Sauer asked whether anyone else felt this way. Mr. Grissom said not in that specific context but some of the press claimed that the MP2 was a bluff and merely the City attempting to utilize benefits to get MP2 approved.

Mr. Grissom stated that he believed the benefits would not have been rescinded had the board not approved MP2.

Due to time constraints, the interview with Mr. Grissom ended before Mr. Sauer had covered all relevant issues. Both parties agreed to schedule another interview of Mr. Grissom.